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No. 1319

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of the Petition of C. K. McINTOSH and JAMES P. BROWN, as Trustees in Bankruptcy of the Estate of A. B. Costigan, Bankrupt

Petitioner's Brief in Reply to Brief for Defendants

Upon Petition by Trustees of Bankrupt's Estate for Review and Revision of the Decree of the United States District Court for the Northern District of California

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Petitioners Brief in Reply to Defendants and Respondents.

Counsel for the defendants and respondents misapprehend, or purposely avoid, the issues presented for consideration and adjudication in the case at bar, and erroneously assume that it is only Sec. 60 of the Bankruptcy act which is invoked, and that one of the essential and necessary elements in a case of voidable preference under that section is fraud.

That section enumerates the several grounds necessary to constitute a voidable preference, and while fraud is not

one of the grounds, it is found in a few cases, but the large majority do not contain that element and are decided alone upon the grounds enumerated in Sec. 60.

Under the first allegation of petitioners bill and the first prayer for relief (trans. pp. 12 to 17) they are entitled to have these deeds decreed to be mortgages.

The bill in this respect states a fact with relation to property in the actual or constructive possession of the trustees, within the custody of the court, and therefore, within the summary powers and jurisdiction of the District Court under Sec. 2 (7) Bankruptcy act.

Our second allegation and the prayer for relief under it is as to a voidable preference under Sec. 60 (Trans. pp. 12 to 17 and 18, 20 to 24.)

Our third allegation and the prayer for relief thereunder appearing in the above transcript and as set forth in our opening brief at pages 16 and 33 is under Sec. 67 a. and d. of the Bankruptcy act, and is on two grounds, the first for failure to record before title had vested in the trustees and the second for constructive fraud.

Let us see by what arguments or evasions counsel for respondents meet these issues and reply to the authorities cited in our opening brief.

The case relied upon by counsel for respondents Meuller vs. Bruss (112 Wis. 406) cited by them on p. p. 1 and 2 of their brief is fired at us without discrimating or designating whether it is to be applied to a voidable preference under Sec. 60 or a void or fradulent lien under Sec. 67.

It will be seen that this was a suit in a State Court brought on the ground of a transfer made by the Bankrupt to hinder, delay and defraud his creditors, not within the

the provisions of Sec. 67 of the Bankruptcy act, but on the alleged fradulent transfer under the State law with only the right of action given under Sec. 70 of the Bankruptcy act.

This case cannot apply to Sec. 60 for Sec. 60 enumerates the several grounds which must be alleged to entitle the trustee to recover and those enumerated in the case cited are not the grounds required by Sec. 60.

Collier on Bankruptcy (5 Ed. 456.)
Western Tie & Timber Co., vs. Brown, 129 Fed. 728.
In re Fort Wayne Elect. Co., 96 Fed. 803.
Brandenburg on Bankruptcy, (3 Ed.) Sec. 947.

The garbled extracts from the bill of complaint made by counsel for defendants (Defendants brief p. 4 to 9) are incorrect, unfair and misleading as will be seen from a full and correct reading of the amendment and par. IX and X of the bill.

In pleading the requirements of Sec. 60 it will be seen from the authorities just above cited, that there is necessarily a mixed averment of law and fact. The necessary averments to meet these requirements of Sec. 60 and in accordance with the authorities just above cited and the precedent contained in Plummer vs Myers, 137 Fed. R. 661, are found in par. VIII of amendment to the bill of complaint (Trans. p. 18) which alleges: "And your orators further allege, that the effect of the transfer of the said real estate so conveyed by said deed of conveyance, will be to enable the said defendants to obtain a greater percentage of the debt due them by the said bankrupt than any other of the bankrupt's creditors of the same class."

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Par. IX and X of the Petitioners bill of complaint (Trans. pp. 22 and 23) disclose that par. X contains an averment which counsel for defendants purposely omitted in ther garbled extracts, and which if frankly quoted, would have destroyed their contention. The first allegation of par. X is as follows:—"Your orators further allege that the said A. B. Costigan at the date he was adjudicated a bankrupt did not own or possess any other property individually not exempt by law, save and except a seat in the Merchant's Exchange of no fixed or definite value and ten shares of stock of the Pacific Motor Car Co., valued at ten dollars; that the real estate heretofore described as conveyed to defendants as your orators are informed verily believe and allege does not exceed in value the sum of ten thousand dollars." Read this par. X, as correctly quoted, in connection with par. IX as recited by counsel for defendants on page 5 of their brief, and it will be seen that the only property owned by the bankrupt at the date he was adjudicated a bankrupt is that named in par. IX and that his indebtedness exceeded this personal property pledged in the sum of Sixty Thousand Dollars; this real estate is named in par. X as worth Ten Thousand Dollars. Hence his indebtedness is Sixty Thousand Dollars and his assets including this real estate is Ten Thousand and Ten Dollars.

We reply to counsel's brief under their second head on page 9 as follows:—

They erroneously assume that a failure to record these deeds under the provisions of Sec. 67 a. and d. must have been done with a fraudulent intent and purpose. There are two grounds under this Section which render the deeds

void; First, the failure to record without any element of fraud; and second where there has been fraud either actual or constructive. It will be observed by reference to Sec. 60, that, the words employed are: "such recording or registering is required." In Section 67 d. the word "required" is not used, but the word "necessary" as follows: —"If a record thereof was necessary in order to impart notice."

The flippant remarks of counsel in relation to the decision of chief justice Marshall in Bailly vs. Greenleaf, 7th Wheat 46, holding, that "the object of all recording laws is to impart notice," and their assertion that the recordation of deeds is *required* by the laws of Utah contrary to the decision of the Supreme Court in Neslin vs. Wells (Defendants brief p. 29) is fully contradicted by a reference to those cases. The Court in the latter case say: "The legislation on this subject prior to 1874, it will be observed, did not require that a mortgage should be recorded in order to be valid, did not in terms declare what should be the legal effect of recording or omitting to record." * * *

"With the general and notorious practice of the people of the territory under those laws, we have no hesitation in deciding, that under the circumstances of the case, there was a duty on the part of Neslin, the vendor, to record his purchase money mortgage towards all who might become subsequent purchasers for value in good faith."

Great reliance is placed by the defendant's counsel on the decision of Judge Ray in re Hunt 139 Fed. 33 which they quote at large in their brief from page 11 to page 24 of defendant's brief.

It will be seen from an examination of this case, as well as the other cases relied upon by counsel for the defendants, that in all of them there were questions relating to the effect of a chattel mortgage recorded *before* the adjudication of bankruptcy, but within the four months period. There is not one of them like the case at bar, and like the case of Lukens cited on page 27 of my opening brief, where the question was as to the effect under Sec. 67 a. and d. of recording a deed of real estate after title by operation of law had vested in the trustees of the bankrupt. In many of the cases, as I shall presently show, where the recordation of the mortgage took place *prior* to the adjudication of bankruptcy, the Courts have held, that, if such recordation had taken place *subsequent* to such adjudication the mortgage or instrument of transfer would have been void under that Section.

Judge Ray in his opinion, so much relied upon by defendants' counsel, (defendants brief p. 15) says: "The laws of New York require the recording of such a mortgage as against purchasers and mortgagors in good faith and for value only." He then quotes the following from the statutes of New York, Sec. 241: "A conveyance of real property * * * may be recorded * * *. Every such conveyance not so recorded is void as against any subsequent purchaser in good faith and for a valuable consideration * * * which conveyance is first duly recorded." It will be observed that the law of New York is similar to Sec. 1214 of the Civil Code of California, but does not contain the additional term "void as against any judgment effecting the title," as contained in Sec. 1214 of the Civil Code. Therefore, when Judge Ray says, that a

trustee in bankruptcy is not a purchaser in good faith nor does he occupy the position of such a purchaser, he states by necessary implication that by reason of Sec 241 of the New York law, such a conveyance not recorded would be void as against a subsequent purchaser. If that is true under the law of New York, it is equally true under Sec. 1214 of the Civil Code of California which makes such unrecorded instrument void as against any judgment effecting the title. It will be seen in the case of Hunt, just cited, that Judge Ray was passing upon the rights of general creditors under the laws of New York who had acquired no interest or property right in any of the bankrupt's property either individually or through a trustee at the date of adjudication of bankruptcy. The rights of the creditors in the case at bar were fixed and determined by a judgment in rem by the adjudication of bankruptcy.

In re Frazier 117 Fed. R. at pp. 748 and 749 the Court holds, that when a bankrupt files his petition to be adjudicated a bankrupt it is a proceeding in rem; that the adjudication which vests title to the bankrupts property in the trustee is equivalent to vesting title in the creditors; that on filing the petition by the bankrupt co-instanti every creditor of the bankrupt becomes an adverse party in the legal proceedings.

This distinction between a creditor of the bankrupt whose interest in the bankrupt's property was not fixed by a judgment in rem prior to the recordation of a mortgage and the creditor whose rights and interests in the property of the bankrupt became fixed and vested by the judgment of adjudication—a judgment in rem—before the recordation

of a deed or mortgage is recognized in all the cases relied upon and cited by counsel for the defendants (defendants brief pp. 27, 28, 34.)

In one of these cases, in re Montague 143 Fed. R. 428, it will be seen, that the code of Virginia like Sec. 1214 Civil Code of California, does not *require* the recordation of the conveyance, but like Sec. 1214 Civil Code of California imposes a penalty for failure to record. Yet the Court in that case held, that the instrument, dated July 12th, 1902, and recorded Feb. 2nd, 1904, *two months before* the maker of the instrument was adjudicated bankrupt, was void as to the trustee in bankruptcy.

In the case of the Security Warehouse Co., vs. Hand 143 Fed. R. 32, the court sustains petitioners' contention, that under Sec. 67 a. and d. of the bankruptcy act a lien not perfected by recording *before* the mortgagor is adjudicated a bankrupt and title vested in his trustee for the benefit of his creditors, does not give the notice necessary to protect the mortgage from the disability imposed by Sec. 1214 Civil Code of California. The Court at pages 42 and 43 says:

"If a chattel mortgage be given in good faith and for a present consideration recording is not obligatory but the imparting of notice is. Recording is one way, another is actual and continued change of possession. If a pledge be similarly given recording is not necessary in order to impart notice because no provision has been made that a record of the fact shall be a notice of the fact. But what is necessary in order to impart notice is the delivery of exclusive and unequivocal possession. We think that Sec.

67 d. does not change 67 a. into the meaning, that claims which for want of record or for other reasons are not good liens as against creditors, are good liens as against the estate, if the lender advanced his money without any actual intent to defraud unsecured creditors. He is chargeable with the constructive intent which is attributed to secrecy."

In the case of Humphrey vs. Tatman 198 U. S. at p. 93, the Supreme Court in passing upon the validity of a chattel mortgage under the laws of Mass. where recording or possession gave it validity against general creditors, quotes with approval the decision of the Supreme Court of Mass. as follows: "It is thereunder those cases that recording or taking possession after the qualification of the trustee would be too late, and it certainly would seem not illogical to hold, that as against him the mortgage was to be treated as non-existant at any earlier date."

In re H. G. Andras Co. Fed. R. 117 p. 561 it is held: "A chattel mortgage not recorded until after the mortgagor had made an assignment for the benefit of his creditors but before he was adjudged a bankrupt; held, insufficient to create a lien under Sec. 67 a. of the bankruptcy act."

As to the effect of recording a mortgage after adjudication Judge Reed in commenting on Sec. 60 and 67 says:

"The two sections must be considered together, Sec. 60 a. relating to the payment or securing of a prior indebtedness and Sec. 67 a. to liens given for a present consideration. And if the latter are recorded at the time of the commencement of bankruptcy proceedings they are not effected thereby."

In the case of Beede 138 Fed. R. at p. 453 Judge Ray in commenting on Sec. 67 a. and d. and not considering Sec. 60 as in case of Hunt says: "All alleged liens voidable by creditors for 'want of record or for other reasons,' including filing, whenever given shall not be liens against his estate—the estate of the bankrupt. This was inserted in this act to prevent secret liens operating to defraud or even mislead creditors by reason of being secret, even if not made to hinder, delay or defraud creditors."

It will be seen from this decision, that the averments in the amended bill of complaint are covered by the intent and meaning of the act as interpreted by Judge Ray. In the case of the First National Bank vs. Connett 142 Fed. R. at p. 37, referred to so confidently by counsel for defendants, the Circuit Court in passing upon the amendment of Feb. 5th, 1903 to Sec. 60 which makes the date of recording the date of the preference, and referring to the old rule which made the State law the guide in determining the requirements of recording says: "In effect this is the adoption without exception of the old rule, that whether and to what extent a chattel mortgage given before but recorded within the four months period, is valid against the trustee in bankruptcy should be determined exclusively by the State law. In our opinion the amendment of 1903 has qualified this rule in respect to the question, whether such a mortgage may constitute a voidable preference under subs a. and b. of Sec. 60. If this has not resulted we fail to see that Congress has accomplished anything by the amendment * * * the voidable element is established by the knowledge of the Bank when its mortgages were recorded."

Constructive Fraud.

While the failure to record is in itself sufficient to render the deeds of mortgages void under Sec. 67 a. and d., yet fraud different and apart from that mentioned in sub. e. and f. of Sec. 67, is sufficient to render such deeds or mortgages void. It is that character of fraud which the Courts have denominated a fraud upon the bankruptcy act.

Counsel for the defendants in their brief have reitterated the insufficiency of the allegations of fraud by the petitioners, and cited authorities to sustain their contention. It will be observed that these authorities do not deal with the sufficiency of allegations in pleading but the sufficiency of proof, so that the insistance of counsel if correct, would require us to spread upon the record in our bill of complaint, the evidence instead of the allegations of fraud.

It has been repeatedly held by the Courts and is a settled principle of practice, that fraud cannot always be proven by the agreement or declarations of the parties, that those who are engaged in fraudulent practices, will employ the language of honesty to conceal their designs and cloak their motives. That therefore, it is proper and permissable to show the existance of a fraudulent design by acts and circumstances ftom which the intention of the parties may be drawn.

Paragraph two of the complainant's bill (trans. p. p. 13 and 14) alleges the agreement under which D. B. Fairbanks, President of the Petaluma Savings Bank, made the loan of Nine Thousand Dollars to Costigan, which is recited as follows in said paragraph: "The said real estate set forth and described in said deeds, to D. B. Fairbanks,

to be redeeded to the said A. B. Costigan on the payment of said note with the interest due and the payment of taxes and insurance."

This is one of the badges of fraud indicating the motives and the designs of the defendants. It was for the purpose of evading and violating article XIII Sec. 5 of the Constitution of California which provides: "Every contract hereafter made by which a debtor is obligated to pay any tax or assessment on money loaned, or on any mortgage * * * shall, as to any interest specified therein and as to such tax or assessment, be null and void."

Burbridge vs. Lemmert, 99 Cal. 493.
Matthews vs. Ormerd, 22 Cal. 369.
Hamion vs. Barrett, 99 Cal. 607.
Germs vs. Jenson, 103 Cal. 374.

It must be born in mind, that the questions presented here by the case at bar are not, as counsel for the defendants erroneously insist, as to the sufficiency of proof, but as to the sufficiency of facts alleged to entitle the petitioners as trustees of the bankrupt's estate, to the relief prayed for by the District Court in the exercise of its summary jurisdiction, on any one or more of the grounds alleged in their bill.

The District Court would certainly, in the exercise of those summary powers over property in *custodia legis*, decree these deeds to be simply mortgages; and with equal certainty it must hold, that this property, the title of which had vested in the trustees by operation of law, could not be divested or impaired by a subsequent recordation of a mere mortgage lien. It would certainly also, in the exercise of

that summary power hold, that an agreement void under the constitution of California, could not be enforced against the trustees of the bankrupt.

WILLIAM A. COULTER,

July 16, 1906. Solicitor for Petitioners.